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SIPDIS

STATE FOR EUR/SE AND EB/IFD
TREASURY FOR INTERNATIONAL AFFAIRS - CPLANTIER AND MMILLS
NSC FOR BRYZA AND MCKIBBEN

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SUBJECT: CENTRAL BANK PREPARES TO WEATHER FRENCH "NO"

REF: A) ANKARA 2732; B) ANKARA 2737; C)_ANKARA 2070

1.(SBU) Summary: Governor Serdengecti and Monetary Policy Committee member Sak told us separately that the Central Bank will focus more on creating the conditions for job-creating growth, in part to head off politicians blaming the Bank for high unemployment. Both Serdengecti and Sak stressed the need for deepening structural reforms. The Governor thought that any market turbulence if the French vote "no" would be manageable, and reiterated his belief that the floating exchange rate regime mitigates current account deficit concerns. End Summary.

Need for Structural Reforms to Achieve Sustainable, Job-Creating Growth.
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2.(SBU) In separate meetings with Central Bank Governor Serdengecti and Monetary Policy Committee Member Guven Sak, both emphasized the need for continued structural reforms to generate sustainable, job-creating growth. Serdengecti said that now that the economy has stabilized--and he is confident this year's inflation target will be achieved--the Central Bank will focus more on sustainable growth, even though its mandate is narrowly-defined as seeking price stability. Serdengecti explained that if the Central Bank does not point out the need for continued structural reforms, politicians will revert to their traditional behavior: as few reforms as possible and more populist initiatives. "They never learn," Serdengecti said. So far in the recovery, price stability has encouraged growth, and if the GOT continues with structural reforms, Serdengecti believes job creation will catch up. Rather than understanding that the success of the program to date provides the Government some room for maneuver to continue reforms, the GOT is in danger of slowing reform momentum. Serdengecti attaches great importance to tax reform-- more to spread the burden than to increase revenue.

3.(SBU) Sak shed light on the Bank's shift in focus by noting the danger that persistently weak employment growth could lead the politicians to blame the Central Bank. He also worried about what might happen when Serdengecti's term comes to an end next year. Given the expected constraints on job growth arising from a strengthening exchange rate and high employment taxes, Sak called for a multi-faceted strategy to encourage employment despite these constraints. He does not subscribe to the theory-recently articulated by IMF Europe Director Deppler-that Turkey was now at a stage of the recovery in which firms would need to start hiring to sustain sales growth. Not that Sak disagreed with the IMF's overall approach: stabilization is expected to create conditions for growth. However, Sak characterized the Fund's approach as a long-term view that will not create jobs in the short run.

4.(SBU) Instead, Sak does not believe job-creation will be "automatic," and sees the need for the GOT to launch a coordinated effort and explain it to the public, with a focus on structural reform supportive of employment growth, as well as "active" labor market initiatives. Lamenting the absence of a Dervis-style economic czar with responsibility for all aspects of economic policy, Sak stressed the need for technological innovation-both through FDI and by other means-and the need to attract private sector investment in all aspects of infrastructure. Sak grumbled about the anti-competitive behavior of Turk Telekom, which, if it remained in the public sector would continue to hold back the economy. He was particularly dismayed to see regulatory actions that are designed to reinforce Turk Telekom's dominant position, with an eye to maximizing the sales-price, rather than considering what is best for the sector as a whole.

5.(SBU) Sak also sees encouraging regional trade, and reducing firms transaction costs in conducting it, as an important way to encourage new forms of economic activity.

The Union of Turkish Chambers of Commerce (TOBB) with which Sak is affiliated, has been actively seeking to encourage trade with the Middle Eastern countries. He contrasted this interest with TUSIAD (which represents the large, Istanbul-based conglomerates) which has not participated in fora like BMENA. Sak finds TUSIAD myopically focused on the EU, missing the point that a Turkey with stable, developed economic ties to its Middle Eastern neighbors is a more attractive candidate for EU membership.

If the French Vote No: Turbulence but no Crisis:
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6.(SBU) Serdengecti said Turks had had extensive discussions with the IMF on what might happen in financial markets if the French vote "no" in their May 29 referendum on the EU constitution. He commended the Government's public line that it is an internal EU matter, downplaying the link to Turkey. Serdengecti admitted, however, that if the French vote "no" there could be turbulence in Turkish markets. Note: This contrasts with Treasury U/S Canakci who, even in private stuck to the GOT line that the referendum was not linked to Turkey's EU candidacy, and downplayed any market impact. End Note. Serdengecti insisted, however, that even a bad scenario, in which there was a precipitous fall in the exchange rate, would be manageable.

Harvard Economists' Current Account Worries:
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¶7. (SBU) The issue of the Turkey's vulnerability to a reversal of short-term portfolio investment flows, and the attendant risk of a sharp exchange rate adjustment was raised by a group of Harvard economists with whom Serdengecti and one of his Vice-Governors met on a recent trip to the U.S. The group, including Turkish-origin Dani Rodrik, as well as Olivier Blanchard, expressed concern about the Central Bank's exchange rate policy and the large current account deficit. Serdengecti responded that the Bank had studied the literature and found that in almost all balance of payments crises, there were fixed exchange rate regimes. Serdengecti admitted the Bank had not expected the magnitude of the current account deficit in 2004, but attributed it to the unexpectedly high GDP growth rate. In 2005, he expects growth to exceed the 5 percent target, but not by much, and sooner or later believes the current account deficit will come down. The exchange rate will eventually adjust but "we don't worry about it." If the short-term investors try to leave they will be effectively locked in. If they try to leave they will take large losses: "we won't defend the level of the exchange rate." A sharp exchange rate adjustment (perhaps up to a twenty percent depreciation) could happen, and could cause difficulty to the Central Bank's disinflation campaign, but would not constitute a crisis.

8.(SBU) Serdengecti, contrasting the Harvard economists to the more market-oriented "Chicago school," said the group advocated measures like increasing bank reserve requirements, more aggressive Central Bank purchases of foreign exchange reserves, and a softer stance on interest rates. Serdengecti also complained about an unhelpful intervention by Ricardo Hausman at a conference in Ankara, in which he said the Central Bank was overly focused on price stability.

Central Banks Diversifying out of Dollars:
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¶9. (SBU) Turning to global risks, Serdengecti questioned the theory that Asian Central Banks would abruptly diversify out of dollar assets. If they believed the dollar will fall, they would have done this earlier, and if they do sell dollars, they should do so quietly and slowly so as not to perturb markets. In Turkey's case, this is not an issue, according to Serdengecti: because of the Central Bank's large Euro liabilities, it keeps two-thirds of its reserves in European currencies.

Comment:

¶10. (SBU) Serdengecti's admission of the risk of post-referendum turbulence suggests a degree of prudent preparation, unlike Canakci's unrealistic line. The Governor's analysis that a bad scenario is unlikely to lead to full-blown crisis matches the local economists' analysis we described in ref c, although it is impossible to completely rule out that a truly horrendous shock would lead to a crisis. The Bank's newfound focus on sustainable growth, arising from worries the Bank will be blamed for weak employment growth, suggests there is an increasing risk of political pressure on the Central Bank.